Why Banks Shun 30 Million Americans

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They are 30 million consumers, representing a quarter of U.S. households, who earn a collective $1.3 trillion a year. But banks don't want to serve them, because they lose money. And the nonfinancial institutions who do serve them may not be offering them much value in the long term.

Welcome to the world of the unbanked and underbanked, who in a weird twist may have fewer banking options after Congress passed legislation aimed at protecting them from high bank fees. So who will serve these consumers, who either use no mainstream financial services or have a checking or savings account but also utilize nonbank financial services such as check cashers, payday lenders, and pawnbrokers? A huge opportunity awaits someone.

In the good old days, banks would have stepped in. They received substantial revenue from interchange and overdraft fees, which essentially subsidized checking and savings accounts. But financial reform passed by Congress in 2010 brought the so-called Durbin amendment, which slashed banks' profits on debit card transactions, and Regulation E, which severely limited the overdraft fees that banks could charge.

In response, many banks have instigated high fees that effectively discourage low-income customers from opening (or keeping) accounts. It's not by accident. To get a sense of why banks aren't terribly interested in serving low income customers, take a look at the following example. Imagine it's 2007, pre-crisis and pre-regulation.

Let's assume each deposit account costs the bank $250 a year to maintain regardless of the balance of the account. Adam deposits $10,000 into his bank account, while Brenda deposits $100. The bank loans out that money at 7 percent interest, making $700 off Adam and $7 off Brenda. They pay each customer an interest rate of 1 percent, meaning that Adam earns $100 in interest, and Brenda earns $1. But since each account costs the bank $250 to maintain, the bank makes $350 off Adam and loses $244 on Brenda.

Although Brenda's deposit earns less in interest than it costs to maintain, the bank also makes money every time she swipes her debit card and every time she incurs an overdraft fee. The latter was particularly lucrative for banks, particularly because low-income customers, who tend to have lower balances, are disproportionately more likely to incur overdraft fees. Ten such charges a year would cover the cost of her checking account, even without revenue from debit card transactions.

Today, that equation looks much different: The bank now lends at 5 percent interest, and pays out 0.1 percent on deposits. Adam's account earns the bank $500, while he only receives $10 in interest; Brenda's garners only $5, and she earns 10 cents in interest. On balance, Adam's account is still profitable for the bank: it nets $245. The bank now loses $245.10 on Brenda's account, and can no longer count on swipe or overdraft fees to make up the difference. There's no incentive to hold onto a large number of low-income accountholders. Quite the opposite.

Big Retailers Fill the Void

By contrast, some big retailers are offering financial services that actively court low-income people. Stores like Walmart and Best Buy can take advantage of economies of scale, as well as boost in-store sales if they offer financial services to shoppers. Beyond this, Walmart doesn't offer deposit accounts, so it doesn't have to worry about the cost of maintaining them, or about paying interest to accountholders. Instead, Walmart makes a profit by charging fees to cash checks or buy prepaid debit cards.

While these one-time fees are more appealing to some people than the ongoing and often hidden fees associated with many big banks, it's questionable whether financial services offered at retailers are actually a bargain. Wal-Mart, for example, charges $3 to cash a check between $300 and $1,000, and levies a host of fees on the prepaid Walmart MoneyCard. Compared with the average 2 percent to 4 percent charged at most street-corner check cashers, Walmart is generally cheaper. But if you cashed two $500 checks, used an automated teller machine (ATM) twice, and reloaded your prepaid card once, you'd incur $16 in fees — far more than mainstream checking accounts.

Even more worrying, however, is the indirect harm of remaining unbanked: Those without access to mainstream financial services are far less likely to save for retirement, college, or emergencies. Bank accounts are more secure than relying on cash. Directly depositing part of your paycheck into a savings account helps you adhere to your budget. The unbanked, however, do not receive these incentives or safeguards.

What about Credit Unions?

Unlike either banks or retailers, credit unions are not-for-profit. They're member-owned, and pay their "shareholders" in the form of lower interest rates and higher yields. In addition, most credit unions have less than $10 billion in assets, and so are exempt from the Durbin amendment. Oddly enough, checking account costs can be 50 percent lower for small institutions. Larger banks face high overhead costs from bank branches, ATMs, and so on, while credit unions and community banks can outsource call centers, payment processing, and ATM networks.

But while credit unions aren't put off by low-income members, they may not be as highly motivated to recruit this population as chain retailers that stand to make a profit. This may in part explain the low profile that credit unions tend to have as compared with their for-profit counterparts.

Given the low fees of credit unions, why do so many people seem to prefer less conventional options to fulfill their financial needs, and why are they content to live without checking or savings accounts? There are several possible explanations. For one thing, the term credit union is still only vaguely familiar to many people. People may not be clear about what services credit unions offer, and they're often unaware that credit unions are not-for-profit institutions, where profits are funneled back to members in the form of lower fees and better interest rates.

In addition, so many people have had bad experiences with unexpected fees at banks that some feel they are better off avoiding financial institutions altogether. Paying a fee at Walmart to cash a check is a one-time deal: You know exactly how much you'll have to pay, and there won't be any surprise fees down the road.

Serving the Underserved

This “underserved” market is considered one of the fastest growing segments in the United States and represents significant potential for banks willing to develop new products and services,” a 2011 study by the consulting firm KPMG concluded. Altogether, the unbanked and underbanked have around $1.3 trillion in income, and spend $5 billion each year paying off predatory loans. A 2009 survey by the Federal Deposit Insurance Corp. found that some 9 billion households were unbanked and another 21 million were underbanked.

Nearly a third of African-American households and a quarter of Hispanic households were underbanked. The KPMG study highlights a number of services that may be important for banks to offer as the number of unbanked and underbanked people rises. For instance, check cashing and bill-pay for noncustomers, as well as international money transfers, are services in demand among these groups. The study found that the number of unbanked and underbanked people is growing as a result of falling credit scores caused by “negative events” in their personal lives that are often linked to the downturn in the economy. Sudden unemployment, for example, can cause a previously banked individual to be forced to leave his or her financial institution.

As the ranks of unbanked and underbanked Americans continue to swell and big banks avoid serving them, big retailers stand to make a profit by finding cost-effective ways to offer financial services to the underserved. In an ironic twist, stores like Walmart have an advantage in many consumers’ eyes because they aren’t affiliated with a mainstream financial institution. In the end, the task will continue to fall to credit unions, big banks, and big retailers to make their case to the unbanked and underbanked and provide services that truly meet the needs and financial limitations of these groups.

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